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MCC FOR JHEWKO AND DFAIR
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SUBJECT: MALAWI: SCENESETTER FOR INITIAL MCC COMPACT
CONSULTATIONS

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Classified By: Ambassador Alan Eastham for reasons 1.4 (B) AND (D).

1. (SBU) SUMMARY: U.S. Mission Lilongwe welcomes the Jan. 13-17 visit of the MCC delegation led by Vice President for Compact Development John Hewko. News of Malawi's selection for compact eligibility has generated considerable excitement; President Bingu wa Mutharika mentioned the achievement in his annual New Year's message to the country. Mutharika heads a government genuinely committed to economic development. The GOM's sound fiscal and monetary policies have tamed inflation, brought exchange rate stability and lowered interest rates. Economic stability, good rains and subsidized fertilizer have yielded two years of strong economic growth, and prospects for more of the same this year. Malawi, a perennially famine-prone nation, is now exporting maize to troubled Zimbabwe. At the same time, much remains to be done to reduce dependence on rain-fed, one-crop agriculture. Key constraints to development include inadequate infrastructure and resultant high costs for power and transport, a poorly educated population weakened by chronic health problems, a legacy of statist policies and a dependency mindset. President Mutharika, who broke with the previous ruling party in 2005, continues to confront a hostile opposition majority in Parliament. His surprise dismissal of Parliament's most recent session in September, 2007 left opposition parties fuming and prompted critics to question his commitment to the rule of law. His prospects for winning a larger share of Parliamentary seats for his newly-formed Democratic Progressive Party (DPP) in national elections in 2009 look good, however, assuming that Malawi can overcome the political impasse long enough to organize a credible election. The approach of 2009 elections will test the GOM's commitment to fiscal prudence. It will make focusing on long-term development issues a challenge for the MCC team, but we welcome the "seat at the table" and major leverage the MCC process will provide, both on economic policy, the election process, and rule of law during the pre-election period. In addition, the Compact process will have to contend with Malawi's one-party legacy, i.e., excessively statist bureaucratic proclivities, along with some questionable mega-projects being pushed by the President. END SUMMARY

2. (SBU) U.S. Mission Lilongwe welcomes the initial visit of the MCC's compact development team Jan 13-17, led by VP John Hewko. Malawi's selection for compact eligibility has generated considerable excitement, particularly among the

country's educated elite. President Mutharika gave prominent mention to compact selection in his annual New Year's message, citing the development as evidence that donors are recognizing his government's successful management of the economy. He also suggested, however, that Malawi would "have access to these funds in 2008," underscoring the need to establish more realistic expectations, both within the GOM and beyond it, for the compact development process during the MCC's first visit here. Finance Minister Goodall Gondwe and his team have reportedly been poring over information about MCC processes.

Economy: Short-Term Success, Long-Term Challenges

¶3. (SBU) President Mutharika had much to brag about during his New Year's address, particularly on the economic front. The GOM's sound fiscal and monetary policies have tamed inflation (on an annual basis, down from 13.9% in 2006 to 8.5% in 2007), brought exchange rate stability and lowered interest rates (down from 25% in 12/2006 to 15% in 11/2007).

Economic stability, good rains and subsidized fertilizer have yielded two years of strong economic growth (7.9% in 2006 and 7.4% in 2007), with prospects for more of the same this year (7.1% projected). This record represents a remarkable turnaround from the worsening economic situation the President inherited from the previous government.

(COMMENT: It may be, in fact, too much of a good thing. Some in the banking sector are becoming concerned that Malawi's economy may be in danger of overheating as a result of inflationary pressures resulting from growth and money supply expansion, coupled with increased spending in anticipation of a rain- and fertilizer-fueled third consecutive good harvest in 2008. END COMMENT) By 2004, the Muluzi administration's burgeoning public spending and

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widespread corruption had obliged donors to cut off most foreign assistance, prompting the GOM to dramatically increase borrowing from domestic banks. Interest rates and inflation rose well into double digits, while Malawi's currency depreciated rapidly against the rand, the euro and the dollar, intensifying Malawi's economic woes. Under the strong leadership of Minister of Finance Goodall Gondwe, who worked a full career at the IMF, the current GOM has instituted fiscal discipline and restored positive working relationships with all major donors, who resumed aid flows. Donors even agreed in 2006, with some operational reservations, to support President Mutharika's signature fertilizer and seed subsidy program, which has suffered from some mismanagement but appears, along with favorable rains, to be increasing yields. Malawi also reached its HIPC debt completion point. On the corruption front, a number of high-level prosecutions -- including against former President Muluzi and some of his ministers -- have stalled or been dropped, but senior business leaders report that the level of GOM corruption has declined noticeably under the current administration.

¶4. (SBU) Beyond the dramatically improved macroeconomic situation, however, much remains to be done to improve Malawi's ability to reliably feed itself and compete in the global economy. While senior GOM officials accept that the private sector must be the engine of Malawi's economic growth and development, efforts to streamline business licensing and encourage investment have stalled -- hence the country's lackluster performance on the MCC business start-up indicator. Finance Minister Gondwe acknowledges in private that the GOM must do better in this area and is focussed on energizing the GOM's efforts in conjunction with a World Bank project. Agriculture, the mainstay of the country's economy, remains dominated by subsistence maize and cassava production, along with small-scale cash crop production (dominated by tobacco, cotton, rice, and vegetables) on small plots without widespread benefit of irrigation. Most sugar

and tea production takes place on a more efficient, commercial scale. Village chiefs continue to control the allocation of "customary" farmland, and permanent title is not given to farmers. Other fundamental challenges include improving Malawi's inadequate economic infrastructure. While the GOM is making some strides in building roads, linking up with the southern African power grid, and privatizing telecommunications, high power and transportation bills and inadequate communications infrastructure continue to lessen Malawi's competitiveness. Progress has been slow on improving the country's most strategic transport links: the rail corridors to Mozambique's Nacala and Beira ports; Nacala is subject to disruptions beyond Malawi's borders, and the Beira corridor has not been rehabilitated since it was closed during the Mozambique war. Malawian businesses continue to import and export through the distant and expensive port of Durban in South Africa or Dar es Salaam in Tanzania, with goods trucked to and from the port by road, through Zambia and Zimbabwe in the case of Durban. Finally, political uncertainty and Malawian leaders' largely inward focus have also contributed to relatively limited foreign investment flows, with the notable exception of a uranium mine under construction in the north and some small-scale portfolio investment.

Politics: A Minority Government that Plays Rough

15. (SBU) Much of Malawi's ongoing political wrangling stems from President Mutharika's decision to break with his political godfather, former president Bakili Muluzi. After failing in attempts to amend the Constitution to permit a third term in office, Muluzi personally selected Mutharika as his successor in 2004 in the expectation that he could continue to rule from behind the curtain. Mutharika, who had little following of his own, then confounded Muluzi by spurning the former president after winning the election, eventually breaking from Muluzi's United Democratic Front (UDF). Trumpeting his campaign against the corruption of his erstwhile associates, Mutharika established the Democratic Progressive Party (DPP) and began wooing former UDF leaders to his new political vehicle using the power of the presidency. The DPP bloc eventually grew to over 70 seats in the 193-seat Parliament, but failed to achieve a majority, or

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even a plurality. Muluzi and opposition's other leader, John Tembo of the Malawi Congress Party, fought back by unsuccessfully pursuing Mutharika's impeachment. When that strategy failed, largely because the MCP and the UDF could not agree on what would happen if Mutharika were removed, opposition leaders sought and won a court judgment to force new elections in districts where Members of Parliament had crossed the aisle to Mutharika's DPP, based on Section 65 of the Constitution. In their most recent showdown, however, Mutharika used his "bully pulpit" to force Parliament to pass his 2007 budget before permitting the Speaker of Parliament to make his necessary ruling on whether the defectors to DPP had lost their seats. The President then violated at least the spirit of an agreement with the opposition by adjourning Parliament in September, 2007, before Section 65 could be taken up. The President must reconvene Parliament, but has not yet indicated when he will do so.

16. (C) Most political actors in Malawi are now focused on Presidential and Parliamentary elections set for mid-2009. Long-delayed local elections may also be held at the same time. In order to hold successful elections, the GOM and opposition parties will need to resolve an ongoing disagreement about the process for appointing new commissioners to the Malawi Electoral Commission (MEC). The issue being litigated is what form the constitutionally-required "consultation" with political parties should take when the Commissioners are appointed. Mutharika and DPP leaders are counting on the country's good

economic performance and the perks of the executive branch to produce an electoral victory that will at least reduce their problems with the opposition. The main challenges the DPP faces are a weak grassroots organization for mobilizing voters and Malawi's traditionally regional voting patterns. Tembo's MCP remains strong in the country's central region, while the DPP and UDF are slugging it out in the country's populous south. The DPP hopes to fill a political vacuum that exists in the sparsely populated north. Mutharika's chances of victory appear reasonably good, though there is still plenty of time for unforeseen developments. The President may be helped by fissures in the UDF that former president Muluzi is creating by insisting on running again himself for the country's top office in spite of uncertainties about the legality of his candidacy for a third, non-consecutive term, as well as poor prospects for victory.

Development Policy: Some Donors Disgruntled

¶7. (C) While donors have universally applauded the current GOM's success in restoring macroeconomic stability, key donor representatives are frustrated with Malawi's combative politics and concerned about the President's perceived disregard for the rule of law. For many European donors in particular, the GOM's failure to convene local elections is symptomatic of President Mutharika's authoritarian tendencies. The President's surprise decision to suspend Parliament in late 2007 only deepened these concerns. There is a degree of division within the donor community over the question of whether international partners should insist on resolution of these problems with Malawi's nascent democracy before ramping up foreign assistance efforts. In this context, some development partners seem to view Malawi's MCC compact selection as an undeserved reward for President Mutharika. Other donors, particularly the U.S. and U.K., believe that the current, favorable environment offers important opportunities for addressing Malawi's chronic development challenges, and that Malawians themselves will have to work their current political wrangling in their own time and in their own way. They cite the fact that the Muluzi government engaged in many of the same kinds of political hardball and maneuvering. Most observers do not expect a more normal rhythm of Parliamentary activity and political give-and-take until after the elections in 2009.

Local Ownership -- And White Elephants

¶8. (C) For its part, the GOM has vociferously insisted that it will lead the development agenda, not donors. President

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Mutharika has laid out a six-part plan called the Malawi Growth and Development Strategy (MGDS) that identifies the GOM's main priorities. The document is fairly general, but offers a basically sound strategy for reducing poverty, improving access to key social services, improving infrastructure and accelerating economic growth. Its flaws include its lack of specificity and a certain flavor of "committee product" in which each ministry of the GOM put forward its pet and parochial projects. However, international partners have generally supported the philosophy behind the plan and attempt to coordinate their efforts within its broad priorities. The GOM has also prepared lists of priorities for public investment. In its support of a locally-designed proposal, the MCC methodology will be fully consistent with these GOM sensibilities. Donors have often been frustrated, however, by the widespread lack of capacity within GOM ministries to design and implement more specific action plans. There is a shortage of appropriately trained personnel to fill high-skill jobs in Malawi, and the GOM hiring machinery moves slowly to staff up

even in priority areas. Low government salaries also pose problems for retention; some development partners have taken to "topping up" the pay of high priority civil servants, particularly health workers. In many cases, donor agencies fill the gaps with reluctant cooperation from the GOM. We have to point out here that more than half of the Malawi government's operating budget, and nearly all of its investment/development budget, are met by donor funds. While this is necessary to provide minimal human needs here, donor priorities tend to ride rough-shod over Malawi's, and there is a clear pattern of dependency in the way the government does its business. Often the first question posed is which donor will pay for the which program.

¶9. (C) While donors support most GOM plans, some Presidential initiatives are clearly white elephants. The most significant such creature is the President's vision for a "Shire-Zambezi Waterway" that would allow multi-modal transport of cargo down Malawi's largest river (the Shire, pronounced She-ray) from a port to be established at Nsanje in far southern Malawi down the Zambezi River to the Indian Ocean. Most experts regard the project, whose price tag has been estimated around \$6 billion in the Malawi government's initial study, as technically difficult, if not impossible, economically unwarranted, and impossibly expensive and impractical. The business community regards upgrading and streamlining Malawi's rail links to Mozambican ports as by far the more logical strategy to make Malawi's exports competitive. The President, however, continues to insist on the importance and feasibility of the Shire-Zambezi project, which appears designed to appeal to Malawians' national pride and imagination, and which will not coincidentally offer important development benefits to the President's home area in southern Malawi.

¶10. (C) Another questionable initiative that the GOM is likely to raise in the MCC context is a plan for "rural growth centers." These centers would aim to serve as hubs for economic activity around the country, and to bring social services closer to rural populations. The President describes these centers in infrastructure/service terms; they would include a health facility, a police station, an all-weather road, a market, a bank, telecommunications, a secondary school, etc., all to be funded from central government or donor resources. The GOM has not yet budgeted significant own resources of its own for what would certainly be a costly series of building projects and a serious staffing challenge, but the government cites projects under way by international donors, including the Clinton-Hunter Development Initiative and the Millennium Villages Project, as support for this concept. While we would certainly have no objections to support for sectoral activities in conjunction with the rural growth centers, we and other donors have concerns about the sustainability and relevance of an elaborate one-size-fits-all program of such complexes throughout the country, given the limited resources available for development in Malawi. The President has also launched the Lilongwe University of Science and Technology (LUSTECH) and has proposed a cancer research center (a memorial to Mrs. Mutharika, who died of cancer in May, 2007) to be established in his home area in the south.

¶11. (C) Comment: We conclude by repeating our warm welcome

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to Mr. Hewko and the MCC team. We are looking forward to supporting and working with MCC in a very challenging political environment. And we want to reiterate that the Malawians are as excited as we have ever seen them to begin the process. One senior official commented to the Ambassador that, "We are going to transform our country with MCC." If we can hold them to this attitude and keep their eyes on the ball as the Compact process moves forward, there's a good chance that this can happen. END COMMENT.
EASTHAM